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THE RATING AGENCIES, THE BAROMETER OF THE COMPANY'S RISK LEVEL

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ABSTRACT

The main target of our research is to present the important rule of the rating agencies in the risk management process, despite the historical presence since 1837, the credibility of the rating agencies data is started in 2000, and we can explain that by the apparition of a new logic in the financial markets as well as the data broadcaster and the internet based market. In our research we will present the working mechanisms of the rating agencies, the importance and limitations of those institutions and their impact on the financial life, this research will try to present some special rating process as well as the Islamic financial Agencies methods, and last but not least we will describe the mechanisms of rating adopted by moody's.

KEYWORDS: Rating, Risks, Ethical Finance, Profitability/risk, The Financial Grad.

I. Introduction:

Following the financial crisis of 1837 in the United States, many companies have made bankruptcies and since this date the debate is opened on the corporate risk and the best tools for its evaluation. But it was not until 1914 that John Moody established the first agency that provides information about the financial quality and levels of corporate risk. Then many credit rating agencies have emerged, including: **S&P Comp. in 1916**, **Statistic Company** in 1922 and **Fitch Publishing Company** in 1924.

Financial ratings conducted by the rating agencies are an opinion, given as a note on the default risk of a debt or the company that issued it. Default risk is the risk of non-repayment of principal or interest on a debt obligation by the borrower.

Rating agencies are providers whose ultimate goal is to provide a reliable and credible information on the risk level of a target. In this paper we will try to see the nature of the risk of the information provided by the rating agencies and we focus our attention on risk assessment approaches by the three main agencies namely Fitch, Standard and Poor's and Moody's.

In order to give an answer to those questions:

- Financial ratings she provides credible information on enterprise risk?
- To what extent can we say that the notes of the rating agencies are sufficient to assess the risk of target companies?
- What approaches adopted by the agencies moody's rating to assess risk levels?
- How can we improve risk management with the information the rating agencies?
- What Differences between financial note and the result of a risk analysis internally?

The first step of our research will target the Theoretical dimension of the problematic, and we will achieve the objectives of our research via a practical approach based on a comparative analysis of different scoring models.

II. Rating agencies and outsourcing risk management:

Rating agencies consists, like the assessment of risk levels processes of qualitative analysis and quantitative analysis. However, it is important to note that the order is reversed. Indeed, within the rating agencies, qualitative analysis is performed first, and condition the quantitative analysis.

A scoring ceiling is established by the qualitative profile of the group. Indeed, in the context of the methodologies applied in the rating agencies, no enhancement rating is possible if the quantitative profile of the group is excellent.

Unlike the process of assessing risk levels, the rating agencies apply a specific methodology for each sector. Besides, I have chosen to present more specifically the methodology of Moody's rating agency for groups of durable consumer goods sector, since it will be used for the empirical study. It should be noted that the items detailed below are only part of the methodology of the rating of Moody's for confidentiality reasons. Indeed, additional elements not listed below, are also taken into account in the credit rating.

Moody's, like the other rating agencies, qualitative analysis is divided into two parts

- Sector Risk analysis,
- Specific Group Risk Analysis

Sectoral risk analysis:

First, it seeks to determine the risks inherent in the group environment, which will allow to prepare a note maximum ceiling for all groups in the sector. This explains why some groups conduct business in a considered risky sector may end up with a fairly low score despite a good financial situation.

The sector rating is based on industry growth prospects, capital intensity (level of investment required for a group to function under normal conditions), the degree of technological expertise it requires for a group to survive, and regulatory risks in the sector.

Specific Group Risk Analysis

After the area in which is located the group studied is noted, we assess the specific risks of the group itself. This analysis will either confirm the previous note or make it worse since an enhancement is impossible. Thus, taking into account the issues the group by analyzing its ability to deal with the threats and exploit the opportunities of its environment. A study of the competitive position of the group is performed. Then, we evaluate the quality of management and the strategy pursued. Finally, the accounting choices are screened to assess the degree of conservatism of the chosen accounting rules.

Moody's, a part of the qualitative analysis of a group of durable consumer goods sector includes the study of its size, its diversification and the strength of its brands.

Therefore, companies have then the mechanisms proposed by the rating agencies to formulate an opinion on the quality of risk in a target for a merger or acquisition or simply investment.

Hence, credit rating agencies are used to inform the financial markets on the financial risk of a number of actors, public and private (including States). They analyze this risk with more resources than do most investors put their opinion and available to all market participants.

III. Importance and limits of the financial rating in the process of Risk Management,

Financial rating provides reliable tools to assess the quality of a financial company. and in its approach, the credit rating takes into account several elements (governance, performance, autonomy and solvency) to assess the financial capacity of a target, and therefore better prevention against the risk of investments or functioning.

Credit ratings, as provides stakeholder processes of risk management, a reliable device to ensure coherent decision making with business and market realities. Of course, the work of rating agencies is not spared criticism, since every evil-rated entity accepts a publication of the quality of its financial health.

Hence the famous phrase of the outgoing French President Sarkozy:

"Being shocked that these companies charge to note states, businesses and even savings products have noted triple AAA hedge funds (hedge funds). These ratings

agencies must be punished. They have not done their job "

The most significant criticisms that affect the rating agencies, the quality of their shareholdings, which is as follows:

- Fitch Ratings is controlled at 50% by the Group Holding French Fimalac also owns VegaFrance and shareholder in other companies. Fimalac is directed by Marc ladreit of Lacharrière. The US media group Hearst Corporation holds 50%.

- Moody's owned before 2000 Dun & Bradstreet group was financially independent since that time. However, since May 2008, it is owned by Moodys Corporation traded which has among its shareholders, at 13%, the investment fund Berkshire Hathaway Inc., itself owned by Warren Buffett.

- Standard & Poor's was acquired in 1966 by the publishing group McGraw-Hill. McGraw-Hill publishes Business Week magazine, many financial newspapers and has many television networks.

Several countries have initiated the establishment of legal texts to better manage the presence of rating agencies in the financial fields. And ensure coherent arbitration by the financial market authorities in each country.

The majority of economists believe that the rating agencies contributed to the worsening of the financial situation of the market at the beginning of the subprime financial crisis, they also think that the notes provided by the rating agencies do not formulate an opinion real on the financial health of companies, and therefore on the level of risk they represent.

Rating agencies have initiated their part, new approaches ratings which do not focus the attention on the financial elements but which also affect non-financial elements in order to refine the analysis of risk levels and the quality of the financial health of the target.

IV. Special Rating Agencies (Islamic Financial Rating Agencies):

In this part we will deal with a very modern and newly publicized Islamic finance approach is the "Islamic financial rating," we talk about the Islamic International Rating Agency and as a scoring approach of Islamic bonds practiced by Standard & Poor's.

➢ *L'Islamic International Rating Agency:*

To rate a company or a bank, the IIRA proceeds by a specific methodology and takes into account several elements to better characterize and assess the financial bank ratings.

The analysis of banks provides in-depth analysis of the following:

➢ Comprehensive Assessment of Market parameters;
➢ Determination of asset quality;
➢ The liquidity and fund management;
➢ The performance of financial flows;
➢ Geography of Capital;
➢ The investment in the real economy;

Summary table of elements of analysis[14]:

The Global Assessment of market parameters	This part aims to give an overall idea of the bank's environment and its relations with its partners, and a strong market is a precondition for a good rating. At this level the scoring takes into consideration especially: the size and nature of the economy, diversification in the market and legal aspects.
Determining the quality of the asset	Key elements considered in the assessment of asset quality are: investment and credit policy (the administrative aspect), the characteristics and composition of the portfolio, the practices of risk management, anticipation of portfolio quality.
Liquidity and funds management	• Assessment of the liquidity ratios by own the IIRA, and the presence of liquidity coast although the bank; • The management of funds must comply with the principles of Islamic finance in holdings which do not exceed 5% off FI activities in the target;
The performance of financial flows;	Analysis of the quality and continuity of financial flows;
Geography of Capital;	• Study the overall governance and performance of shareholders • The investment in the real economy; • Check that the entity focused its strategy oriented to actual investments;

The financial assessment by the IIRA is in the form of a qualitative document that measures the quality of the different elements that we described in the last table, the IIRA publishes an annual ranking of participatory banking based on its analysis.

➢ *The rating of Islamic bonds (sukuk)*

Islamic bonds (sukuk) are debt securities that may be issued either by the companies (Corporate Sukuk) or by States (Sovereign Sukuk). The S & P approach takes into account the categories of Islamic Bonds and notes each category in a special way.

➢ *Method of standard & poor's:*

The S&P method is almost similar to the method used in conventional finance but in Islamic finance, S & P considers the regulatory specificities of Genesis.

Risk profile analysis of bank activity	Economic risk
	Political risk
	The nature of activities
	position in the market
	Diversification / Concentration
	Governance Quality
Analyze the risk management	Risk level perception
	Existence of a risk culture
	adequation of risk tools to the business
Financial risk analysis	Exposure to different types of risks (credit, market ...)
	Profitability issues
	Funding level
	Financial flexibility é

S&P Finance islamique, Mohamed DAMAK, Fichier PPT [en ligne]

V. Illustration of Moody's credit rating model (Fictional Case):

a. Return analysis :

By Moody's methodology, quantitative analysis of this group is mainly focused on the following two ways:

➢ Profitability Analysis
➢ Analysis of Financial Policy

Furthermore, it should be noted that the following analyzes do not fully reflect the methodology of rating Moody's as many other information from either of the annual report is an interview with the rating agencies management are exploited.

Note		Aaa	Aa	A	Baa	Ba	B	Caa	Ca
Factor	Note	1	3	6	9	12	15	18	20
EBITDA Margin (%)		> 21 %	18 – 21	15 - 18	12 – 15	9 - 12	6 - 9	3 – 6	< 3 %

Return on assets (12% of total weight):

➢ Net income / Total assets = 7.57%

➢ According to Moody's segmentation, the profitability of the group's assets is denoted B, quite low.

Note		Aaa	Aa	A	Baa	Ba	B	Caa	Ca
Factor	Note	1	3	6	9	12	15	18	20
Return on assets (%)		> 21%	18 – 21	15 - 18	12 – 15	8 - 12	4 - 8	0 - 4	< 0 %

Therefore, the profitability of this group is estimated at B, considered quite low. This rating is 25% weight in the final rating for quantitative analysis.

b. Analysis of Financial Policy :

Financial policy (21% of total weight): it is considered that the group has a very stable financial policy, which gives it a Aaa rating.

Note		Aaa	Aa	A	Baa	Ba	B	Caa	Ca
Factor	Note	1	3	6	9	12	15	18	20
Financial apperciation		Rated as the highest quality and lowest credit risk :	judged to be of high quality and are subject to very low credit risk	considered upper-medium grade and are subject to low credit risk	subject to moderate credit risk. They are considered medium-grade and as such may possess certain speculative characteristics	Ba are judged to have speculative elements and are subject to substantial credit risk	B are considered speculative and are subject to high credit risk	Caa are judged to be of poor standing and are subject to very high credit risk	Ca are highly speculative and are likely in, or very near, default, with some prospect of recovery of principal and interes

Leverage (17% of total weight):

- Debt / EBITDAR = 0.15

- According to Moody's segmentation, leverage the group noted Aaa, which is great.

Note		Aaa	Aa	A	Baa	Ba	B	Caa	Ca
Factor	Note	1	3	6	9	12	15	18	20
Financial debt /GOP (%)		< 0.5	0,5 – 1	1 - 2	2 - 3	3 - 4	4 - 6	6 - 8	> 8

Liquidity (10% of total weight):

- Free Cash Flow / Financial Debt = 135%

- According to Moody's segmentation, the liquidity ratio is noted Aaa, which is great.

Note		Aaa	Aa	A	Baa	Ba	B	Caa	Ca
Fact	Note	1	3	6	9	12	15	18	20
CF / Financial debt %		> 45 %	35 - 45	28 - 35	21 - 28	14 - 21	7 - 14	0 - 7	< 0 %

In this part there is a consideration of the cash flows related to operating activities and free cash flow (FCF least the pay-back of the year).

Therefore, the financial policy of the group is valued at Aaa rated as excellent. This rating is 75% weight in the final rating for quantitative analysis.

For the final rating conducted by quantitative analysis, just do the weighted sum of the numeric equivalent of the previously assigned ratings.

Indeed, the group B obtained for the analysis of profitability, which equals the numerical figure 15, weighted at 25%. Regarding fiscal policy, the group noted Aaa, equivalent to 1, weighted 75%. Therefore, the final rating is obtained by the calculation:

15 * 25% + 1 * 75/100 = 4.5. However, the figure 4.5 corresponds to the Moody's A1 rating.

Thus, this group at the end of the quantitative analysis gets Moody's A1 rating, which means it has a very good credit quality, high repayment capacity, but eventually it could be vulnerable to changes economic conditions.

This analysis allowed us to determine that the mark awarded by the rating agencies, makes a general opinion on the financial health of the company.

>>>Making it easier, of course, the decision taking into account the risk of activity and the risk of bankruptcy.

The rating agencies, like Moody's, then are service providers that gives a clear idea on the target and that helps us in our approach to prevention against the risk, especially at the level of investment (acquisition, M & A ... etc).

The approach adopted by Moody's is an approach that gives an opinion on the financial quality of business while taking into consideration all financial aggregates.

Conclusion:

The rating agencies adopt a logical approach in the process of analyzing the financial risk, since they take into account all financial aggregates (Performance, Autonomy, solvency, liquidity ...). For Moody's gave us a clear idea about the steps and the weight used for each aggregate to pave the way for the final score of a target.

In short, we can say that the rating agencies are true service providers in terms of risk management and the stakeholders of the risk management process can use the rating agencies notes for good decision making and prevention against the risks.

This question leads us to approach the concept of ethics in financial rating, and focus on the importance of ethical finance in the strategic approach to financial rating.

Ethical and financial rating finances are an amalgam that allows us to tone finance by adopting an ethical and responsible approach, supported by the ability of the financial credibility rating to investment.

This could encourage better funding to basic projects and especially responsible ethical ethical finance is an integral part of the extra-financial approach to corporate ratings.

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